Assessments

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Highlights

If the elections produce a hung Parliament, it will likely reduce the chances of a new government introducing disruptive measures that could worry markets, but it will also delay the introduction of much-needed reforms to boost economic growth.

Rome will pressure the European Union to give Italy more room to cut taxes and increase spending, but moderate parties are more likely than their anti-establishment rivals to seek a compromise with Brussels.

The next Italian government will have to deal with high debt levels, slow economic growth, widespread social discontent with the political system and declining influence on EU affairs.

Italians are heading to the ballot box this weekend, but it's anyone's guess as to who will ultimately emerge as the victor. What is clear, however, is that the results on March 4 will be felt well beyond Italy's borders. A likely push by the next Italian government to cut taxes and to increase public spending could put the country on a collision course with EU institutions and could generate concerns in international markets about Italy's efforts to maintain a balanced budget and to reduce its staggering debt levels. No matter who is in charge – and the prospect of drawn-out coalition negotiations suggests a new administration won't be in charge anytime soon – any Italian government will have to deal with a weak economy and a heavy debt burden, as well as an electorate that is unhappy with politicians in Rome and Brussels.

The polls are a battle among four main players: the anti-establishment Five Star Movement, the center-left Democratic Party, the center-right Forza Italia and the right-wing Northern League. In spite of their different campaign promises, they all agree on one basic point: Brussels must give the Italian government leeway on taxes and public spending after years of unpopular austerity measures. With every front-runner seemingly intent on loosening the purse strings, the next Italian government could struggle to maintain a balanced budget, which would raise questions about Italy's ability to repay its massive debt, which currently stands at 130 percent of gross domestic product.

According to opinion polls, the elections are likely to produce a hung Parliament, which could prompt weeks, if not months, of negotiations among the parties to cobble together a government.

Until the parties reach a prospective coalition, a caretaker administration would govern the country. Such a situation is unlikely to produce a significant shock to financial markets or pose an immediate threat to the eurozone, because the caretaker government would seek to avoid any disruptive policy moves. An interim administration, however, would postpone the introduction of much-needed reforms to revitalize the economy. President Sergio Mattarella does wield the power to dissolve Parliament and call for new elections if talks on a coalition prove less than fruitful, but he is expected to avoid such an action for as long as possible, because snap polls would only generate additional uncertainty about Italy's future.

EU institutions and financial markets would welcome a government led by Forza

Italia or the Democratic Party due to the expectation that they could reach compromises with Brussels on fiscal policies. In contrast, a government led by the Five Star Movement or the Northern League, both of which have leveled heavy criticisms at the bloc, is more likely to pursue unilateral action on spending hikes or tax cuts without consulting Brussels – which would raise concerns in international markets about the sustainability of Italy's finances.

One of the biggest issues on the incoming government's to-do list will revolve around managing Italy's fragile economic recovery. The country's GDP expanded by about 1.5 percent in 2017 (similar figures are expected this year), but the economy is still smaller than it was when the financial crisis began a decade ago. Unemployment, meanwhile, is running at roughly 11 percent, which exceeds the eurozone average of 8.7 percent. According to data from the Organization for Economic Cooperation and Development, Italy's productivity growth over the past decade has trailed that of other major economies, such as the United States and Germany, due to excessive red tape, high personal and corporate taxes, corruption and inflexible labor legislation.

Large public debt is another headache awaiting the next administration. Rome has benefited in recent years from the European Central Bank's bond-buying program to extend the average maturity of its bonds and reduce interest payments. While this has somewhat reduced Italy's vulnerability to market volatility, the country will struggle to escape its debt due to slow economic growth.

And because of the high cost of servicing debt, a new government will have little wiggle room to cut taxes or to increase public spending – which is what most political parties have promised to do. As a result, the incoming administration will be forced to navigate a tricky path between Scylla and Charybdis; it must decide whether it wishes to run a moderate deficit, which would alienate significant portions of the electorate, or abandon austerity, which could scare investors and lead to higher borrowing costs for the country.

The heavy burden of Italy's sovereign debt will constrain Rome's room to maneuver when it comes to reducing taxes for businesses and households or introducing policies to combat poverty. Against this backdrop, a growing number of Italians could blame the euro for their country's economic troubles. Before adopting the common European currency, Italian governments used to devalue the lira to regain competitiveness during crises. Over the past decade, several economists and politicians in Italy and overseas have argued that the country needs to leave the euro to regain an independent monetary policy. While many Italians dislike the euro, most wish to retain it out of fear of the unpredictable consequences of an exit – at least for now.

Strengthening Italy's banks is an additional task awaiting the new administration. In recent years, a modest economic recovery and an effort by banks to divest themselves of their bad debt (by reselling it to other institutions, for example) have helped lenders improve their portfolios. However, Italy's nonperforming loans still represent about 17 percent of all loans in the banking sector – one of the highest proportions in the eurozone. Because of these high levels of bad debt, it has been difficult for banks to grant credit to customers, depriving the economy of one of its main sources of growth.

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Apart from the domestic challenges, the country's next leaders must define Rome's place within the European Union. The European Commission is unlikely to accept a renegotiation of the Fiscal Compact, which increased EU oversight of the fiscal policies of the member states, but it could give Rome some room to maneuver, especially if a pro-EU government enters office.

Italy will be front and center during Continent-wide negotiations to introduce common deposit insurance for eurozone banks and further integrate the capital markets of EU member states. Southern European countries, led by France, are likely to push to include Italy in these initiatives. Germany, however, will be hesitant, while other Northern European countries will use Italy as an excuse to delay – or at least water down – the proposed reforms. Ultimately, the union will strive to ensure Italy participates in the next stage of eurozone integration, but the country will be a recurrent topic of disputes between its partners.

Beyond these short-term debates, Italy faces a bigger challenge: retaining its influence in Europe. In the past, Rome succeeded in bringing its weight to bear on

EU decisions and securing the appointment of Italians to key EU positions, such as the presidency of the European Commission and the European Central Bank. In the years ahead, however, Italy's weak economy and turbulent politics could limit its say on EU policy. Aware of the potential for a reduced Continental role, Rome is currently working on a pact with Paris to deepen their political cooperation. Italy fears that a rising France could try to decide the bloc's future in cooperation with Germany, relegating Italy to a secondary position.

Regardless of which government takes control after the March 4 elections, issues varying from social discontent to demography and migration will shape the country's future. Years of slow economic growth and high unemployment have harmed young workers, and they will continue to provide fertile ground for anti-establishment sentiment in Italy, regardless of the Five Star Movement's success at the polls.

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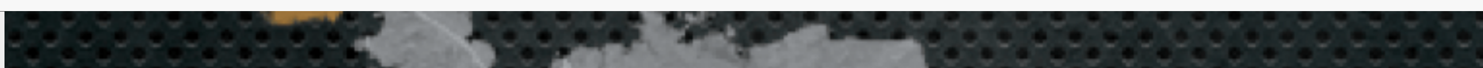
Social discontent is also growing as the popular and economic differences between the country's prosperous north and poorer south stoke regionalist sentiment. In the coming years, the northern regions are likely to make more vociferous calls for self-government and exert greater pressure on Rome to grant them more control over their taxes. In the south, the pervasive presence of criminal organizations will discourage foreign investment there, thus aggravating economic underdevelopment.

And like many places in the developed world, Italy's demographic trends are likely to provide little succor to the country's authorities. Italy has one of the lowest fertility rates in the world (1.3 children per woman), while life expectancy continues to increase (83.5 years at present). Since the start of the financial crisis in 2008, emigration – particularly among young workers – has also jumped. According to the EU's statistical office, Eurostat, Italy's population has already peaked at about 60 million and will decline in the coming decades, just as the number of retirees rises, leading to fewer workers who are capable of propping up the country's already-strained pension and health-care sectors. Immigration, too, has been central to the present campaign, and it is likely to dominate future votes as well, because the continuing influx of African and Middle Eastern economic migrants could inflame nationalist sentiment.

Buffeted by pressures from within and without, Italy's problems go well beyond the current election. Its numerous structural issues will affect the decisions of governments and voters for years to come. Moderate, pro-Europe parties might retain power after this weekend's polls, but Italy will continue to be a source of concern for its eurozone peers. It is a founding member of the European Union, and its political and economic elites remain largely committed to membership in the bloc. But with no elixir to cure what ails Italy, many in the country could soon question their desire to stay in the EU family.

Italy Looms on the Eurozone's Horizon



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